

Letter of Findings Number: 01-20130546
Income Tax
For Tax Years 2010, 2011, and 2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

ISSUE

I. Adjusted Gross Income Tax – Research Expense Tax Credit.

Authority: IC § 6-3.1-4-1 et seq.; IC § 6-3.1-4-2; IC § 6-3.1-4-4; IC § 6-8.1-5-1(c); I.R.C. §41; Treas. Reg. 1.53-3; Treas. Reg. 1.41-9; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012).

Taxpayers protest adjustment of Indiana research expense tax credit.

STATEMENT OF FACTS

Taxpayers are Husband and Wife. Husband is the sole shareholder of "S-Corp.," an Indiana S-corporation. S-Corp. reported qualified research expenses during tax years 2010, 2011, and 2012. Husband, as the sole shareholder of S-Corp., reported an Indiana research expense credit on Taxpayers' Indiana income tax returns for the same tax years. During an investigation, the Indiana Department of Revenue ("Department") adjusted the amount of research expense credit claimed on Taxpayers' individual income tax returns, asserting that the research expense tax credit could not be taken during the tax years at issue. The Department issued proposed assessments for base tax and interest. Taxpayers protest the proposed assessments of base tax. An administrative hearing was held, and this Letter of Findings results. Additional facts will be provided as needed.

I. Adjusted Gross Income Tax – Research Expense Tax Credit.

DISCUSSION

Taxpayers protest the proposed assessments of base tax which result from the adjustment of the research expense credit claimed on Taxpayers' individual income tax returns. All tax assessments are prima facie evidence that the Department's claim for the tax is valid, and the taxpayer bears the burden of proving that an assessment is incorrect. IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). The issue before the Department is whether Taxpayers met their burden to prove the Department's assessment is incorrect.

The Department adjusted the research expense tax credit reported on Taxpayers' individual income tax returns. It determined that the research expense tax credit could not be taken in the tax years at issue because, for the tax years at issue, S-Corp. reported losses on Husband's Indiana Form K-1. The Department stated that "the losses do not create any tax attributable to the [Husband's] interest in [S-Corp.]" Since there was no tax attributable to Husband's interest in S-Corp. during the tax years at issue, the research expense tax credit could not be taken in those years.

The Department did not consider Husband's wages from S-Corp. as part of his interest in S-Corp. for purposes of calculating the Indiana research expense tax credit. The audit report states that "the wages are separately reported and do not increase [Husband's] interest in [S-Corp.]" Taxpayers argue that Husband's wages from S-Corp. should be included in Husband's interest in S-Corp. for the purposes of calculating the Indiana research expense tax credit. Taxpayers argue that if Husband's wages from S-Corp. are included in his interest in S-Corp., Taxpayers may take the research expense tax credit in the tax years at issue.

The amounts of the research expense tax credits are not currently in dispute.

Indiana provides for a research expense tax credit. IC § 6-3.1-4-1 et seq. "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-2. IC § 6-3.1-4-4 states:

The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

I.R.C. § 41(g)(4) as in effect on January 1, 2001 provides that the research expense tax credit is passed through to the shareholder of an S Corporation and that the research expense tax credit may not exceed the amount of tax attributable to the shareholder's taxable income which is allocable to the shareholder's interest in an S Corporation. Treas. Reg. 1.41-9(c), as in effect on January 1, 2001, states that the special pass through rules found in I.R.C. § 41(g) shall be applied in accordance with Treas. Reg. 1.53-3, which identifies the components of a "shareholder's taxable income which is allocable to the shareholder's interest in an S Corporation." It states in relevant part:

The portion of a taxpayer's taxable income attributable to an interest in a . . . subchapter S corporation is the amount of income from that entity the taxpayer is required to include in gross income, reduced by

- (i) The amount of the deductions allowed to the taxpayer that are attributable to the taxpayer's interest in the entity; and
- (ii) A proportionate share of the deductions allowed to the taxpayer not attributable to a specific activity (as defined in paragraph (e)). . . .

Treas. Reg. 1.53-3(c). A shareholder's interest in an S Corporation is calculated by determining first "the amount of income from that [S Corporation] the taxpayer is required to include in gross income" Id. Example 1 of Treas. Reg. 1.53-3(c) identifies what must be included in a shareholder's gross income attributed to an S-corporation, beginning with "Salary" or "Income from S Corporation." Therefore, pursuant to Treas. Reg. 1.53-3, a shareholder's total interest in an S-corporation includes the shareholder's salary or wages from the S Corporation. Pursuant to Treas. Reg. 1.41-9(c), this principle applies to the research expense tax credit special pass through rules identified in Internal Revenue Code Section 41(g). Pursuant to IC § 6-3.1-4-4 and its incorporation of I.R.C. § 41(g), this principle also applies to the calculation of Indiana's research expense tax credit.

In this case, the Department did not consider Husband's wages from S-Corp. as part of his interest in S-Corp. for the purposes of calculating the Indiana research expense tax credit. Taxpayers' original Indiana income tax returns included Husband's wages from S-Corp. as part of his interest in S-Corp. for purposes of calculating the Indiana research expense credit for the tax years at issue. Since the amounts of the research expense tax credits are not currently in dispute, Taxpayers' protest is sustained.

FINDING

Taxpayers' protest is sustained.

Posted: 07/30/2014 by Legislative Services Agency
An [html](#) version of this document.